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C O N F I D E N T I A L SECTION 01 OF 02 MOSCOW 010777

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DEPT FOR EUR/RUS WARLICK, HOLMAN, AND GUHA

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DOE FOR HARBERT/EKIMOFF

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TAGS: EPET ENRG ECON PREL RS

SUBJECT: RUSSIAN ENERGY:CASPIAN PIPELINE CONSORTIUM UPDATE

Classified By: Econ M/C Pamela Quanrud. Reasons 1.4 (b/d).

¶1. (C) Summary. This fall the Caspian Pipeline Consortium (CPC) faces both its long-awaited expansion decision and a serious tax case being brought against the CPC's Russian (CPC-R) operations. Expansion will once again be on the agenda of the September 27-28 shareholders meeting, where western shareholders are expected to react to a GOR/GOK MOU signed in July that lays out one possible way forward for expansion. The tax case, which threatens to cost the consortium's Russian operations \$700-800 million in back taxes and penalties, has already made it through its first test in court, and CPC-R's appeal will be heard in November.

¶2. (C) New CPC General Director, Vladimir Razdukhov told us September 19 that he is hopeful he can find a way to synthesize Russian and Western shareholder interests to allow the expansion to proceed before the technical studies done two years ago in preparation for the expansion expire at year's end. Ian MacDonald, Razdukhov's predecessor and new head of Chevron (please protect) is also quietly optimistic that a way forward can be found on expansion, which would pave the way for Chevron to participate in the Burgas-Alexandroupolis (BA) Bosphorus bypass pipeline. End Summary.

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Expansion Plans
Still in Play

¶3. (C) In separate conversations with Razdukhov and MacDonald, both said much is hanging on the reaction of western shareholders this coming week to a July 1 MOU signed between the GOR and GOK (Energy Ministers Khristenko and Bakhtvkhzoa), which outlines the conditions under which both governments are prepared to move forward with CPC expansion. Razdukhov characterized the MOU as a breakthrough in the GOR's policy toward CPC expansion, but realistically assessed that western shareholders would unlikely accept the terms of the MOU without amendment. MacDonald expressed a similar confidence that a reasonable way forward could be found based on the MOU, but was unsure if ExxonMobil, in particular, wanted the deal badly enough at this point in time. We have not seen the MOU, but both Razdukhov and MacDonald tell us it addresses the underlying financial structure of the consortium, something the GOR has sought for years, and MacDonald's comments suggest that the MOU could be the basis for a way forward -- at least for Chevron.

¶ 4. (C) Timing is also an issue, as the technical study which lays the groundwork for the expansion is set to expire at the end of this year. Should the shareholders not find a way forward by then, the consortium would be forced to decide whether to commission and pay for a new study, something both Razdukhov and MacDonald hoped could be avoided.

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The Tax Issue

¶ 5. (C) Razdukhov and MacDonald outlined for us as well a new issue facing the Russian operations of the consortium -- a tax case which alleges that CPC-R has been improperly claiming a deduction for interest on its debt payments. CPC-R received assurances in writing from Deputy Finance Minister Sergey Shatalov in 1996 that the interest payments were legal, and subsequent changes to the tax code would seem to confirm that opinion. Nevertheless, CPC-R lost an appeal in administrative court two weeks ago, and has begun to make installment payments on some \$175 million in back taxes for 2002 and 2003. Cases are being opened for tax years 2004 and 2005 right now, based on the same allegations. All told, if the court rules consistently against CPC-R, the consortium will owe some \$700-800 million in back taxes and penalties, and will face an annual increase in its tax obligation in excess of \$100 million. MacDonald, as the head of CPC-R during this period, is worried that criminal charges could be brought against him as well. (Note: the magnitude of the tax claim against CPC-R could automatically throw the case into criminal court, but this has not happened as yet.)

¶ 6. (C) CPC-R lost its first trial in the case two weeks ago. The appeal will be heard in November. According to MacDonald, CPC has always won these types of cases on appeal

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in the past, but he was hesitant to predict victory this time. Razdukhov was more hopeful that the consortium would win on appeal. Should the appeal be unsuccessful, then the case will go to the Court of Cassation in March. If, in the end, the case goes against CPC, MacDonald predicted Chevron's senior management would lose its appetite for CPC expansion.

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The BA Bypass Pipeline

¶ 7. (C) When asked to comment on Chevron's interest in BA, MacDonald stated simply, "If CPC is expanded we will participate; if it isn't, we won't. We've told the Russians that." He also confirmed Chevron's position that the Greek and Bulgarian governments should not get a stake in the consortium was just an opening negotiating position. However, while not giving us a firm number, he did indicate that his company would not agree to Greece's and Bulgaria's push for a one-third stake.

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Comment

¶ 8. (C) The quest for CPC expansion continues, and much of what we report here is similar to previous turning points: a three-month deadline; tension between the western and Russian shareholders and between the two major western shareholders; and external pressure being brought to bear -- this time in the form of a tax case. What may be different this time is Razdukhov, who brings a Russian accent to CPC's front office and with its longtime relationships within the GOR -- including with PM Fradkov, who was Minister for Foreign Economic Relations (MFER) during Razdukhov's stint as MFER Deputy Minister. Razdukhov talked about two possible paths forward for CPC: either find a way forward amicably on expansion, or take the consortium into bankruptcy, which would put it in international arbitration. MacDonald had always shied away from the latter option as head of CPC, but Razdukhov seems willing to put it more clearly on the table.

This will certainly change the dynamics in the room, but in ways which Razdukhov himself admits will be unpredictable. However, he did not, he tells us, take over CPC to watch over its demise. This week's shareholder meeting will be the first test of whether he has the skills to keep the consortium together.

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¶9. (C) On the tax problem, the Ambassador will raise this issue when he meets later this week with Finance Minister Kudrin. Regarding BA, neither MacDonald previously nor any other Chevron official we have spoken to has been as blunt as this regarding Chevron's stance on BA. Without Chevron's oil, BA's economics deteriorate but we suspect that, if the GOR wants BA enough, they will find a way to get enough Russian oil into the pipeline.

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